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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 579

KENDALL A. YOUNG AND ELISABETH R. YOUNG,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioners, Kendall A. Young and Elisabeth R. Young, hereby respectfully request this Honorable Court to issue writ of Certiorari to the United States Court of Appeals for the Fourth Circuit to review the decision and judgment of that Court, which affirmed the decision of the Tax Court of the United States in these proceedings (R., p. 20).

The Tax Court, Judge Hill presiding, affirmed the determinations by the Commissioner of Internal Revenue of deficiencies in Petitioners' income tax liabilities for the year 1945 (R., p. 18).

OPINIONS BELOW

The opinion of the Court of Appeals is reported in ..... Fed. (2nd) ....., No. 6674, and appears on page 20 of this record.

The findings of fact and opinion of the Tax Court are reported in ..... T. C. ....., No. 33830, and appear at pages 13 to 18 of this record.

JURISDICTION

The opinion of the Court of Appeals was entered on December 9, 1953 (R., p. 20).

The jurisdiction of this Court is invoked under Section 1254 of Title 28 United States Code.

QUESTION PRESENTED

Does enrichment, through increase in value of property (appreciation) distributed in kind in complete liquidation without cash or "boot", of an insolvent corporation, constitute realized income under the Sixteenth Amendment to the Constitution of the United States?

SUMMARY STATEMENT OF FACTS

The facts were stipulated (R., pp. 11 to 13). They may be summarized as follows:

The Petitioners, Kendall A. Young and Elisabeth R. Young were husband and wife during the taxable year 1945, and were residents of the State of Maryland and

filed a joint income tax return for that year. Young was a certified public accountant and a practicing tax attorney.

During 1944 Young was given (without consideration) a one-third (⅓) interest in the common stock of a Maryland corporation, known as Better Housing, Inc., which was engaged in the building of houses for war workers.

Many attempts were made by the corporation to dispose of these houses during 1945, first to the tenants, who had option leases, and later in the Fall of 1945 as an entirety.

Upon the failure of the latter efforts, differences of opinion arose among the three stockholders, including Young, regarding future operations of the corporation.

By appropriate action of the Board of Directors of the corporation at a meeting held on November 15, 1945, Better Housing, Inc. was dissolved. The machinery, tools, fixtures and automobile belonging to the corporation were sold.

On December 1, 1945, Young received one-third (⅓) of the remaining (150) houses which were conveyed to him, subject to the then existing mortgages. Young's share of these houses had a cost or book value of $257,454.35 and mortgages thereon of $260,357.49.

The remaining assets consisting of cash, and accounts receivable ($12,068.99) and accounts payable ($5,945.84) were turned over to Young for liquidation and payment. After much litigation these items netted $740.92 and the proceeds were distributed in 1950. One-third of ($12,068.99) minus ($5,945.84) assigned to Young (1945) was, net, $2,041.05. Young's allocated share actually realized in 1950 was $246.97.

The following is a condensed statement showing the computation of the $52,783.56 proposed by the Commissioner as additional income:

	Company Costs (R. p. 10)	*F. M. V. Proposed Commissioner*	*Appreciation*
Share of cash, etc. not distributed (1945)	2,041.05	2,041.05	—
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Total	259,495.40	313,141.05	53,645.65
Mortgages assumed	260,357.49	260,357.49	—
Deficit	862.09		
Total			53,645.65
Less Deficit			862.09
Additional income proposed by Commissioner (R., p. 9)			52,783.56

In subsequent years (specifically 1946 — R., pp. 12). Young sold twelve of the houses received in liquidation and reported the income derived from such sales on his return, either on completed sale or on the installment basis.

The Commissioner determined that this $52,783.56 was realized income in the year 1945. The Commissioner made other adjustments and added a 5 per cent negligence penalty, all of which are incidental to the main question.

The Tax Court sustained the Commissioner (R., p. 18).

The Court of Appeals affirmed the Tax Court (R., p. 20).

SPECIFICATIONS OF ERROR

The Court of Appeals Erred:

1. In affirming the judgment of the Tax Court.

2. In holding that the increment in value (appreciation) in the amount of $52,783.56, was realized income under the Sixteenth Amendment to the Constitution of the United States.

3. In basing its decision solely upon the provisions of Section 115C of the Internal Revenue Code.

REASONS FOR GRANTING THE WRIT

The Federal questions herein involved was decided by the Court below probably in conflict with applicable decisions of this Court.

Both of the lower Courts based their decision on the Hellmich v. Hellman Case, 276 U. S. 233, 48 S. Ct. 244. It is hard to imagine the facts of a case being so dissimilar from the case before this Court, and yet the decision therein is said to be controlling. It is respectfully submitted that the Hellman decision could not apply to any case unless it arose under the 1918 Act, because the laws have been so radically changed.

A brief review of the entire record is herein related — (Fully discussed in the Brief).

Two brothers each owned a one-half interest in a corporation, with a capital stock of $27,000.00 and with undivided profits of $31,545.58. There was an appropriate resolution dissolving the corporation, as of December 31, 1919. "A", one of the brothers, reported $15,004.55 (one-half of the undivided profits) as a dividend under Section

201A (ordinary dividend) subject only to surtax. The Commissioner determined that the dividend should have been taxed under Section 201C (Providing that liquidating dividends shall be treated as other gains or losses). Section 201C did not state that these dividends were subject to normal and surtax; but the Commissioner so ruled and assessed accordingly. "A" paid the tax under protest and brought suit for recovery in the District Court, Eastern Division of Missouri — March Term, 1925.

The Court held that 201A and 201C were supplement subject to surtax only, and rendered judgment for Plaintiff. The Eighth Circuit affirmed.

It would appear from the argument that if the corporation had declared a dividend before passing the liquidating resolution, that the dividend would have been subject to surtax only (201A).

The Court said it was only concerned with surplus and profits accruing since February 28, 1913, — what became of the capital stock does not appear in the record. Both sides concede the single question to be, whether the dividend was subject to surtax only, or both normal and surtax. There was nothing in the record of any property distributed in kind; therefore, it was apparently 100 per cent cash distribution.

While this case was reversed by this Court, it is doubtful that upon proper presentation its opinion would have been the same, because the Congress, omitted this contentious Section (201C) entirely from the 1921 Act, and in the 1924 Act provided fair and proper treatment for liquidating dividends (capital gain and loss and limitation of tax rates).

A comparison of the facts of the Hellman Case and the instant one are not the least similar; here, we have the extremes of liquidating dividends — the Hellman Case, 100 per cent cash distribution of the undivided profits and surplus, and the instant case involving no undivided profits or surplus — merely alleged increment in value or appreciation, of a 100 per cent distribution in kind.

As to the law generally, it is admitted that the Congress has the power to exempt by the way of income or by way of deduction that which is taxable under the Sixteenth Amendment, but it is equally well settled that the Congress *does not* have the power to tax *unrealized income.*

In dealing with the question of unrealized income in reference to stock dividends, and the powers of the Congress in reference thereto, this Court said in Eisner v. Macomber, 252 U. S. 189; 40 S. Ct. 189; at page 206:

> "Congress cannot by any definition of income, it may adopt, conclude the matter, since it cannot by legislation alter the Constitution from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

The distinction between realized and unrealized income under the Sixteenth Amendment had its inception in the Macomber Case, which held a stock dividend was not realized income. It said, "There must be a realization of the gain or *increment* to constitute income within the meaning of the Sixteenth Amendment." and it defined income as follows (at page 207):

> "Income may be defined as the gain derived from capital, from labor or from both combined providing it be understood to include profit, gain through a sale or conversion of capital assets. The gain derived from capital. Here we have the essential matter, not a gain

> accruing to capital, not a growth or increment of value in the investment, but a gain, a profit something of exchangeable value, proceeding from the property, severed from the capital, or employed or coming in, being derived — that is received and drawn by the recipient for his separate use and benefit and disposal. That is income derived from capital. Nothing else answers the description."

also on pages 214 and 215:

> "*Enrichment through increase in value of capital is not income in any proper meaning of the term.*" (Italics ours.)

In the United States v. Safety Car Heating and Lighting Co., 297 U. S. 88, (56 S. Ct. 353) at page 99 it was said:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of men."

3. The principle question involved (distribution in liquidation) would, in an ordinary case, arise under Section 115C of the Internal Revenue Code, which states briefly, "amounts distributed in complete liquidation shall be treated as in full payment of stock." The gain or loss determined under Section III, "* * * the amount realized — sum of money plus fair market value of other property, but only to the extent of Section 112." This latter section deals with non-recognition cases, principally reorganization cases.

Statutes when enacted must necessarily be general in terms, especially when they must cover a multitude of situations. Their interpretation must be gathered from the intentions of the Congress and the organic law as evolved by the Courts.

The problem — corporate distributions in liquidation.

(a) The most frequent dissolutions that the Congress had in mind were the corporations with many stockholders in which distribution in kind would be impracticable. They were generally under Court Supervision (Receivership or Bankruptcy). All the assets were sold, — often sacrificed by inopportune sale, in order to make an equitable cash distribution and avoid litigation involving favoritism in distribution in kind. These can be attributed to economic reasons. There is no question of appreciation — seldom any undivided profits or surplus — 100 per cent cash distribution.

(b) The big problem — liquidations of Personal Holding corporations.

They accumulated huge surpluses or undivided profits — securities greatly advanced in market value. The only reason for their existence was the avoidance of personal income taxes, by forming a corporation and paying a lesser corporate tax on their income. Their liquidation was generally one of tax expediency, to avoid payment of corporate tax through corporate sale of their securities; and (until the 1950 Act) avoidance of ordinary taxes on the undistributed profits or surplus.

Since the inception of the Income Tax laws Congress has been plagued with tax avoidance.

A review of the Senate Finance Committee Reports (covered more fully in Brief) as early as the 1924 Act, Report 398, indicated that the changes (1924 Act) "were designed to prevent the avoidance of income taxes — in the reorganization sections in reference to basis for depreciation, and future gain or loss." Under the 1918 Act a person

could exchange a bond for cash and another bond, without tax under the *exchange* provisions, and if the bond held, showed a loss — they would sell and establish a deductible loss. Certain distributions were formerly treated as a capital gain, when in effect they were dividends out of earnings, or accumulated surplus.

In the instant case, both the lower Courts based their decision, in sustaining the Commissioner of Internal Revenue, on Section 115C. In connection therewith, the Supreme Court in White v. United States, 305 U. S. 281, said:

> "Section 115C, 111, and 112 standing alone give no clue to the part which a stockholder's loss or liquidation is to play, in computation of the tax, any more than they give in the case of gain or loss upon the sale or exchange of property. In each case they tell how the gain or loss is to be determined and declare how it should be recognized. It follows that in one case, as in the other we must turn to the general provisions of the act to learn what recognition is to be given to the gain or loss under Sections 12, 22, 23, as supplemented by 101."

It is suggested that this admonition as to the testing of any one Section with the general provisions of the act, connotes in addition thereto — the intention of the Congress as gleaned from their reports on the passage of the particular legislation — interpretations by this Court and finally the Constitution and Amendments thereto of the United States.

We do not suggest that Section 115C is unconstitutional, but the income developed by Section 115C must be such as is recognized by exemplification of the Macomber decision under Section 22A of the Internal Review Code:

> "Gross income includes in general compensation for personal and professional services, business income,

profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law."

The Congress in connection with the Sixteenth Amendment, was confronted with exchange cases involving the taxation of unrealized income. This required a choice of the acceptance of the so called "closed rule" or "open rule". In the closed rule the gain or loss was recognized in the year the exchange took place. In the open rule the gain or loss was not recognized until the time of actual sale (actual reduction). The open rule has been accepted by the Congress because the closed rule would be unworkable and would throw our economy into chaos, if a taxpayer were obliged to pay a tax before he had money to pay it. These were practical considerations in the administration of the law in addition to the hardships which would be imposed on the taxpayer.

The following are situations involving unrealized income in which taxation is deferred until money is actually received:

(a) Inventories — option to price at, lower of cost or market.

(b) Farmers' crops — profit reported in year of sale (realization) rather than the year of harvest.

(c) Distribution of dividend in stock of another corporation — no recognition of increment of value taxable to corporation.

(d) Gifts — no recognition of increment of value to donor — donee takes subject to value in hands of donor for future sale.

(e) Sales on deferment or installment plan recognized to amount of cash received during the year plus deposit.

The above specific instances of non-realization are either through legislative grace or constitutional prohibition.

It is respectfully suggested to this Court that, for taxation purposes, dissolutions of business enterprises must necessarily be separated into two parts — 1. The amount that represents undivided profits and surplus, and, 2. The increment or appreciation, if any, in "distribution in kind". In number one the Congress has the authority to tax as ordinary or capital gain — it being a matter of legislative grace; but in number two, the increment or appreciation in the capital assets is subject to the qualification of realized income under the Sixteenth Amendment. With the Court's permission, we again emphasize the suggestion, that if it were not for the undivided earnings in the corporate organization, and the avoidances of taxes in connection therewith, there would be no need for provisions similar to 115C of the Revenue Code.

The organization of a partnership is an excellent example. In this type of organization the earnings are 100 per cent taxable each year to the partners — the item of undistributed earnings does not appear as such, they become part of the capital each year. When the partnership is dissolved there can be no attempt to tax the increment or appreciation of the capital assets, if such be distributed. There are no provisions in the Revenue Acts on dissolutions of partnerships such as 115C, on corporations. However Section 113(a)(13) provides the basis for subsequent or future sales, and in doing so states: "* * * If a partnership distributes its assets in kind, and not in cash, the partner realizes no gain or loss until he disposes of the property re-

ceived in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property * * *"

We maintain that this is equally true in the case of a corporation, without any undivided earnings, and such was the distribution of the Better Housing, Inc., to the Petitioners.

The history and development of this phase of the law is fully developed in the Brief.

An interesting article on, *Realization: (Income) Administrative or Constitutional Requirement?* appears in January 1953 issue, page 173 of the "Tax Law Review". To quote from footnote(2):

> "Neither in the United States nor in England has any proposal to tax *unrealized* gains (capital or otherwise) received serious consideration from the legislature, tax authorities, or the Courts."

The development of the law of realization, in reference to appreciation, by the Congress and the Courts, has never been extended beyond the cash or "boot".

We have made an exhaustive research on the point involved in this case and can find no decisions with facts even remotely similar.

There are many instances where taxpayers have been forced to pay taxes because of the absence of a well defined decision of this Court, rather than assume the risk of prolonged and uncertain litigation.

The question involved in this case undoubtedly is a question of importance that should be settled, in order to resolve

the doubts existing in the minds of the lower Courts, the Treasury Department, and the taxpayers.

It is respectfully submitted that the Courts below have failed to apply the decisions in the White and Macomber cases and have erroneously applied the decision in the Hellman Case.

Wherefore, your petitioners respectfully pray that writ of certiorari should be granted.

Respectfully submitted,

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The Petitioners, Kendall A. Young and Elisabeth R. Young were husband and wife during the taxable year 1945, and were residents of the State of Maryland and filed a joint income tax return for that year. Young was a certified public accountant and a practicing tax attorney.

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Many attempts were made by the corporation to dispose of these houses during 1945, first to the tenants, who had option leases, and later in the Fall of 1945 as an entirety.

Upon the failure of the latter efforts, differences of opinion arose among the three stockholders, including Young, regarding future operations of the corporation.

By appropriate action of the Board of Directors of the corporation at a meeting held on November 15, 1945, Better Housing, Inc. was dissolved. The machinery, tools, fixtures and automobile belonging to the corporation were sold.

On December 1, 1945, Young received one-third (⅓) of the remaining (150) houses which were conveyed to him,

subject to the then existing mortgages. Young's share of these houses had a cost or book value of $257,454.35 and mortgages thereon of $260,357.49.

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SPECIFICATIONS OF ERROR

The Court of Appeals Erred:

1. In affirming the judgment of the Tax Court.

2. In holding that the increment in value (appreciation) in the amount of $52,783.56, was realized income under the Sixteenth Amendment to the Constitution of the United States.

3. In basing its decision solely upon the provisions of Section 115C of the Internal Revenue Code.

SUMMARY OF ARGUMENT

1. That Section 115C standing alone is not conclusive as to a stockholder's gain in a corporate liquidation.

2. There was no realized income subject to tax under the Sixteenth Amendment to the Constitution.

3. Taxation is and should be a practical thing, and it should be predicated upon actualities and not fiction, legal or otherwise.

POINT I.

THAT SECTION 115C STANDING ALONE IS NOT CONCLUSIVE AS TO A STOCKHOLDER'S GAIN IN A CORPORATE LIQUIDATION.

In the instant case both of the lower Courts based their decisions and opinions on Section 115C of the Internal Revenue Code.

The principle question involved (distribution in liquidation) would, in an ordinary case, arise under Section 115C of the Internal Revenue Code, which states briefly, "* * * amounts distributed in complete liquidation shall be treated as in full payment of stock." The gain or loss determined under Section 111, "* * * the amount realized — sum of money plus fair market value of other property, but only to the extent of Section 112." This latter section deals with non-recognition cases, principally reorganization cases.

Statutes when enacted must necessarily be general in terms, especially when they must cover a multitude of situations. Their interpretation must be gathered from the intentions of the Congress and the organic law as evolved by the Courts.

The problem — corporate distributions in liquidation.

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(b) The big problem — liquidations of Personal Holding corporations.

They accumulated huge surpluses or undivided profits — securities greatly advanced in market value. The only reason for their existence was the avoidance of personal income taxes, by forming a corporation and paying a lesser corporate tax on their income. Their liquidation was generally one of tax expediency, to avoid payment of corporate tax, through corporate sale of their securities, and (until the 1950 Act) avoidance of ordinary taxes on the undistributed profits or surplus. Since the inception of the Income Tax Laws, Congress has been plagued with tax avoidance.

A review of the Senate Finance Committee reports indicates the problem and their intention concerning corporate liquidation. In Senate report 398, 68th Congress, First Session, quote: "* * * A liquidating dividend is in effect a sale by the stockholder of his stock to the corporation, he surrenders his interest in the corporation and *receives money in place thereof*" (Italics ours). It was also indicated in this report, that the changes in the 1924 Act were designed to: "Prevent the avoidance of income Taxes — to escape taxes by distributing as capital gains what are in effect dividends out of earnings — the imposition of a 50 per cent penalty on unnecessary accumulations of surplus or undivided profits."

Senate Report 558 (73rd Congress) in amending Section 115C, said: "To prevent avoidance of surtax through liquidations of corporations, Congress found it necessary to

place gain on liquidations on a different basis from gains on sales" (Collapsible corporations).

Senate Report 627, 78th Congress, First Session, page 48, in providing for special liquidations, Sec. 112-B-7, while not applicable to this case it is offered as historical development of the law.

> "The *unrealized appreciation* in the value of corporate assets existing immediately prior to the liquidation, the recognition of the gain attributal to which it is the purpose of this section to postpone * * *" (Italics ours).

Again in Senate Report 737, 82nd Congress, First Session, Section 316, extending provision of Section 112(B)(7) to 1952, provides, "* * * only the portion which represents undistributed earnings is to be taxed as ordinary income." There are several examples set out on pages 10, 257, Prentice-Hall (1951) showing the application of these new provisions.

An analysis of the Senate Reports dealing with liquidations and the evolution of the law pertaining thereto, would appear to be designed to prevent devious methods of distributing the undivided profits on the one hand, and to discourage personal holding corporations, (whose purpose it is to retain profits) and lastly, certain "loop-holes" in the exchange or reorganization provision.

It is suggested that if it were not for the item of "undivided profits" in the corporate organization and the avoidance of taxes in connection therewith, there would be no necessity for provisions on corporate liquidations such as Section 115C.

The organization of a partnership is an excellent example. In this type of organization the earnings are 100 per cent taxable each year to the individual partners. There is no problem of undistributed earnings. When the partnership is dissolved there are no provisions in the tax laws that could possibly involve the increment in value of its assets — even to the extent of the cash involved. The only provision in reference to dissolutions of partnerships is Section 113(a)(13) providing the basis for subsequent or future sales, "* * * If a partnership distributes its assets in kind, and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. * * *"

We do not think any one can seriously contend that this is a matter of legislative grace. Any attempt to tax this increment would be in violation of the Sixteenth Amendment. The situation of a partnership is exactly the same as a corporation without undivided profits. No increment in value of its assets can be taxed. The Congress does not have the power to specifically tax unrealized income, and it has never made the attempt.

Both of the lower Courts have based their decisions on Section 115C, and Hellmich v. Hellman, 276 U. S. 233, 48 S. Ct. 244, which we will discuss in detail later.

In connection with 115C, this Court said in White v. United States, 305 U. S. 281, 59 S. Ct. 179:

> "Section 115C, 111, and 112 *standing alone give no clue to the part which a stockholder's loss on liquidation is to play, in computation of the tax, any more than they give in the case of gain or loss upon the sale or exchange of property.* In each case they tell how the gain or loss is to be determined and declare how it should be recognized. *It follows that in one case, as*

> *in the other we must turn to the general provisions of the act to learn what recognition is to be given to the gain or loss under Sections 12, 22, 23,* as supplemented by 101." (Italics ours.)

It is suggested that this admonition as to the testing of any one Section with the general provisions of the act, connotes in addition thereto — the intention of the Congress as gleaned from their reports on the passage of the particular legislation — interpretations by this Court, and finally the Constitution and Amendments thereto.

We do not suggest that 115C is unconstitutional, but suggest that the income developed under 115C must be such as is recognized, by exemplification of the Macomber decision, under Section 22A of the Internal Revenue Code:

> "Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law."

The lower Courts hold the Hellman case to be controlling, and yet it is hard to imagine the facts of a case being so dissimilar. Since so much emphasis has been placed on this case, the following abstract is offered:

Two brothers, each owned a one-half interest in the capital stock of Hellman & Sons Fur & Wool Company. At December 31, 1919, the time of dissolution, the paid-up capital stock was $27,000, and the undivided profits were $46,466.27 of which $31,545.58 represented earnings since February 28, 1913. The brothers reported their share of $31,545.58 in their tax return as a dividend under Section 201A, which defined a dividend as any distribution, etc.

The Commissioner of Internal Revenue determined that it was a dividend under Section 201C, which provided "* * * amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock, and any gain or profit realized thereby shall be treated as other gains or profits." Section 216(a) provided dividends shall be exempt from normal tax.

The Commissioner assessed the tax on the basis of both normal and surtax. The Hellmans paid the tax under protest and brought suit for recovery in the District Court, Eastern Division of Missouri, March Term 1925. The District Court said:

> "I am dealing here, so far as Petitioner is concerned (by which alone I am bound, and with which alone I am concerned) with surplus and profits accruing since February 28, 1913. What became of the capital stock does not appear nor is it in issue or pertinent, so far as the Petitioner is concerned. Briefs on both sides concede that the single question is whether said sum ($15,004.55) was or was not subject to normal tax, which is taxable by law as ordinary income."

The Court was impressed with the argument in reference to the timing of the dividend. It was suggested that if the dividend had been declared before the resolution on dissolution, (which both sides concede), the dividend would have been subject to surtax only. The Court held that 201(a) and 201(c) were supplemental. The Court of Appeals, Eighth Circuit affirmed (18 Fed. (2nd) 239). Among other things it said, "201(a) and (c) should be construed together — one should not be permitted to defeat the other, supplemental thereto * * * Courts will avoid, if possible, an interpretation of the statute which results in injustice * * *. The manner of distribution, if this position is

correct, determines taxability, and not the character of income."

This Court reversed the Eighth Circuit. It is doubtful that the resultant opinion would be the same if the case had been properly presented, because Congress, before this Court's decision, had changed the contentious section (201C) by omitting it entirely from the 1921 Act, and in the 1924 Act provided fair and proper treatment (capital gain and loss, and limitation of tax rate provisions). These latter provisions have been continued to date. All the Hellman decision holds, it is respectfully submitted, is that the liquidating dividend (under 1918 Act), is taxable as ordinary income subject to both normal and surtax.

Therefore we say, that the facts are dissimilar — here we have the extremes of liquidating dividends — Hellman Case, 100 per cent cash distribution — the instant case, 100 per cent distribution in kind — in the Hellman Case distribution was based solely on "undivided profits" accruing since February 28, 1913 — in the instant case, *no undivided profits*, merely alleged increment (appreciation) in value. How could it be possible to find more divergent facts; different provisions of law, under different Revenue Acts, and yet cite the Hellman Case as authority. We submit the Hellman Case is outmoded by changes in the Revenue Acts and could have no application to the facts in the instant case, even under the Revenue Act of 1918.

Point II.

THERE WAS NO REALIZED INCOME SUBJECT TO TAX UNDER THE SIXTEENTH AMENDMENT TO THE CONSTITUTION.

The word "income" has a different meaning to different people under different forms of economy. Its meaning is clear to the man in the street, but takes on complications

as the economist or taxing authority takes over. The laws of the land say that all taxes must be paid in the *lawful money* of the land. So called income taxes are supposed to be *a sharing of earnings with the government* rather than a business deduction. The share belonging to the government, however, must be paid in the *lawful money* of the government — all of which gives added significance to the word "income". The complexities of the industrial world and the necessary devices to record the operations and transactions — particularly the gains or profits — have given a new meaning to income or profit — "accrued income" and as a compensatory token — "accrued deductions". It is admitted that this, under proper conditions, tends to stabilize income and deductions; but, as in all situations, such entries representing obligations must be paid in the medium of exchange — "money".

In connection with the evolution of "income", the term had to be further defined into "realized" and "unrealized" income; and may in the future, require further refinements; but, as long as the Government demands the *payment of taxes in lawful money,* any refinement, we respectfully submit, must still connote "money".

The distinction between "realized" and "unrealized income" under the Sixteenth Amendment had its inception in the Macomber Case, which held a stock dividend was not realized income. It said, "There must be a realization of the gain or *increment* to constitute income within the meaning of the Sixteenth Amendment." And it defined income as follows (page 207):

> "Income may be defined as the gain derived from capital, from labor or from both combined providing it be understood to include profit, gain through a sale or conversion of capital assets. The gain derived from

> capital. Here we have the essential matter, not a gain accruing to capital, not a growth or increment of value in the investment, but a gain, a profit something of exchangeable value, proceeding from the property, severed from the capital, or employed or coming in, being derived — that is received and drawn by the recipient for his separate use and benefit and disposal. That is income derived from capital. Nothing else answers the description."

also on pages 214 and 215:

> *"Enrichment through increase in value of capital is not income in any proper meaning of the term."* (Italics ours.)

In United States v. Safety Car Heating and Lighting Co., 297 U. S. 88, 56 S. Ct. 353, it was said:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions if any, it is income as the word is known in the common speech of men."

While there has been and still is considerable groping in determining when increment in capital has been realized so as to be taxable, there is substantial agreement that amounts received as a return of capital or investment are not income within the general meaning of that term and may not be taxed under the Sixteenth Amendment.

The doctrine of the equivalent of cash, is, of course, only of assistance in determining what is to be treated as income. It does not follow because the taxpayer has received property which has a cash equivalent that it is necessarily taxable. The theory is only applicable where there would have been a tax, *if cash* had been received. This because it would be a hardship ordinarily for the taxpayer who would not

have a source from which the tax could be paid, and it might result in deductions for losses as yet unrealized.

Judge Hill (App. 16 second paragraph) "If petitioners are complaining of hardship — from the fact they have no cash, arguments based on hardship are better directed to Congress * * *."

The petitioners seek no sympathy; however, they have a right to expect the Courts to uphold the law as promulgated by Congress and evolved by this Court. The lower Courts failed to pass on the question of *"unrealized" income* — the principle issue in the instant case. In his opinion, it is respectfully submitted, Judge Hill distorted the meaning of income as laid down in the Macomber case when he said,

"This was drawn," (meaning the houses with Mortgages in excess of their cost or book value) "by Kendall A. Young for his separate use, benefit and disposal." That phrase was taken out of context from the Macomber definition of income on page 207.

In this general connection and in reference to the powers of the Congress, it was said in the Macomber case at page 206:

> *"Congress cannot by any definition of income, it may adopt, conclude the matter,* since it cannot by legislation alter the Constitution from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised." (Italics ours.)

If the lower Court meant to infer that these properties should or could have been sold to provide for the taxes, this question was answered in our brief below, from the

following — again from the Macomber case, at pages 212 and 213:

> "It is said that a stockholder may sell the new shares acquired in the stock dividend and so he may, if he can find a buyer. It is equally true that if he does sell and in doing so he realized a profit, like any other, is income and taxable. Yet, without selling, the stockholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the stock dividend * * * *nothing could more clearly show that to tax a stock dividend is to tax a capital increase and not income, than this demonstration, that in the nature of things it requires conversion of capital in order to pay a tax.*" (Italics ours.)

It is respectfully submitted to this Court that the stock dividend of the Standard Oil Company of California is far more liquid than any piece of real estate, and notwithstanding, this Court did not suggest that any stock be sold.

An interesting article on, *Realization: (Income) Administrative or Constitutional Requirement?* appears in the January 1953 issue, page 173 of the "Tax Law Review." to quote from footnote (2):

> "Neither in the United States nor in England has any proposal to tax *unrealized* gains (capital or otherwise) received serious consideration from the legislature, tax authorities, or the Courts."

We respectfully submit, that if it were possible to tax "unrealized income" under the Sixteenth Amendment, the impracticability of its administration would restrict our economy to such extent it would stifle its growth.

POINT III.

TAXATION IS AND SHOULD BE, A PRACTICAL THING, AND IT SHOULD BE PREDICATED UPON ACTUALITIES AND NOT FICTION, LEGAL OR OTHERWISE.

The Congress has recognized the practical consideration in the administration of the law, specifically in reference to deferred income, and, in addition, the possible hardships upon taxpayers. The following are situations involving unrealized income in which taxation is deferred until money is actually received:

(a) Inventories of all business enterprises: the option to price at the lower cost or market, in order to determine the taxable profits for the year involved.

(b) Farmer's crops: allowing the farmer to report the income in the year of sale, rather than the year of harvest regardless of the number of intervening years or the ups and downs of the market.

(c) Distribution of a dividend in stock of another corporation — no recognition of increment of value taxable to corporation (General Utilities 296 U. S. 200).

(d) Gifts — no recognition of increment in value to donor — donee takes subject to value in hands of donor for future sales.

In the case of Taft v. Bowers, 278 U. S. 479, it was said:

> *"When she sold the stock* she actually got the original sum invested (Donor Bases) *plus the entire appreciation;* and out of the latter only, was she called on to pay the tax demanded."

(e) Sales on deferment or installment plan — here there is recognized only the amount of cash in the way of initial deposit and payment on account made during the taxable year.

In Moore v. Commissioner, 48 Fed. (2nd) 526, Cert. den., 284 U. S. 620, there was involved the sale of stock upon a cash deposit, and the balance guaranteed by a substantial corporation (third party). The Court said:

> "The taxpayer did not realize the profit from the sale in 1918, but realized the profit during the ensuing years, and it is the general contemplations of the statutes that a tax shall be levied on profits which are realized and not deferred. He has not actually received that profit; he has received no income out of which to pay the tax; the statute and the regulations give him the right to spread the tax; to deny him the right, would in our opinion, result in a hardship to taxpayers generally."

Let us examine the tax consequences of a hypothetical example:

(a) Corporation — without undivided profits distributed in liquidation to stockholder "S" fifty houses that have a cost of $5,000.00 each, subject to a $5,000.00 mortgage; and with a fair market value of $10,000.00 each; and no cash distribution.

(b) Partnership — distributees in liquidation fifty houses to partner "P" under the same conditions as to cost, etc., as in (a).

The question of undivided profits is eliminated to make it comparable to the partnership organization. There was no equity in the houses. In each instance there was an increment or appreciation of $5,000.00 each. Yet, the Com-

missioner attempts to tax the corporate stockholder's unrealized profit under Section 115C of the Internal Revenue Code and not the partner, "P." We respectfully submit that it would be in violation of the Sixteenth Amendment. We think the test laid down in the Macomber case is profound: "S" did not receive any income in which to pay the tax, and the very fact that he would be obliged to sell some of these properties, or other property if fortunate, *is a demonstration that the tax is on capital and not income.*

CONCLUSION

We respectfully submit that:

1. The facts are clear and reveal the insolvency of the corporation at the time of dissolution (in that its liabilities exceeded its assets). Under these circumstances there could be no problem of "undivided profits." We have shown the "increment in value" to be $53,645.65, reduced by the Petitioner's share of the insolvency ($862.09) leaving the item of $52,783.56, the amount proposed by the Commissioner as additional taxable income. This is "unrealized income" in its most elemental form.

2. The law in reference thereto is equally clear:

(a) That any section of any Act must be read in connection with the whole thereof, and the Constitution and Amendments thereto of the United States.

(b) That the Congress has never shown any inclination to tax "increment in value" and further, it does not have the power to call something "income" which is not income.

(c) Both in the United States and England "unrealized income" is not subject to tax as income under income tax provisions.

Your Petitioners respectfully pray that the Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit be granted.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 579

KENDALL A. YOUNG AND ELISABETH R. YOUNG,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 13-18) is not officially reported. The opinion of the Court of Appeals (R. 20) is reported at 208 F. 2d 795.

JURISDICTION

The judgment of the Court of Appeals was entered on December 9, 1953. (R. 21.) The petition for a writ of certiorari was filed on February 5, 1954. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the difference between the cost basis of stock in a corporation and the fair market value of the assets received in complete liquidation is taxable in the year such assets were received.

STATUTE AND REGULATIONS INVOLVED

The pertinent parts of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 8-9.

STATEMENT

This case involves an asserted deficiency in personal income tax for the calendar year 1945. The facts, as stipulated by the parties (R. 11-13) and as found by the Tax Court (R. 13-18), may be summarized as follows:

Taxpayers, during the taxable year 1945, were husband and wife, and residents of the State of Maryland. Taxpayer Kendall A. Young (hereinafter referred to as taxpayer) was a certified public accountant and a practicing tax attorney. (R. 11.)

In 1944, the taxpayer acquired a one-third interest in the common stock of a Maryland corporation known as Better Housing, Inc., engaged in the building of approximately 150 houses for war workers. Taxpayer was given his one-third interest in the common stock of Better Housing, Inc., without consideration. The cost basis of such stock to taxpayer was zero. The last of the approximately 150 houses was completed in the early part of 1945, and the houses were thereupon rented. Subsequent to completion, unsuccessful efforts were made by

the corporation to sell the houses to their occupants. (R. 11.)

In the summer of 1945, further unsuccessful attempts were made by the corporation to sell the houses as a block. Upon the failure of these efforts, differences of opinion regarding future operations by the corporation arose among the stockholders and it was decided by them to liquidate the corporation completely and to distribute the assets in kind to each of the three stockholders, including taxpayer, subject to liabilities. (R. 11.)

The machinery, tools, fixtures, and automobiles belonging to the corporation were sold in the early fall of 1945. By appropriate action of the board of directors at a meeting held on November 15, 1945, Better Housing, Inc., was dissolved. All the assets of the dissolved corporation in the form of cash, accounts receivable subject to accounts payable, and 150 houses and lots subject to construction mortgages were completely distributed to the three stockholders, including taxpayer, on December 1, 1945. (R. 12.)

On account of his one-third interest in Better Housing, Inc., taxpayer received on December 1, 1945, 50 houses and lots and certain miscellaneous assets in the form of cash and accounts receivable. The fair market value on December 1, 1945, of the houses and lots subject to mortgages received by taxpayer on liquidation of Better Housing, Inc., was determined by the Commissioner in his notice of deficiency as $50,742.51, and the fair market

value of certain miscellaneous assets consisting of cash and accounts receivable subject to accounts payable received by the taxpayer was determined by the Commissioner in his notice of deficiency as $2,041.05, totaling $52,783.56. (R. 12.)

Taxpayers filed a joint income tax return for the calendar year 1945. They failed to report any part of the amount received on liquidation of Better Housing, Inc., as income for such year. (R. 12.)

In redetermining taxpayers' income for the calendar year 1945, the Commissioner included therein as additional income 50 percent of $52,783.56 ($26,391.78) as a long-term capital gain. (R. 12.)

In 1946, taxpayer sold 12 of the houses received on the liquidation of Better Housing, Inc., and reported income derived from such sales on his return of income for such year, either on the completed sale or on the installment sale basis. (R. 12-13.)

The Tax Court held that the amount received by the taxpayer for his stock in the complete liquidation of Better Housing, Inc., is to be treated as in full payment thereof, and that the difference between the taxpayer's basis and the fair market value of the property received is to be taxed as a long-term capital gain in 1945. (R. 14-17.) The Court of Appeals affirmed the Tax Court's decision. (R. 20-21.)

ARGUMENT

1. The Court of Appeals was correct in determining that the difference between the basis of tax-

payer's capital stock and the fair market value of the property received by him upon the liquidation of Better Housing, Inc. was to be treated as capital gain. The holding of the court below is supported by the decision of this Court in *Hellmich* v. *Hellman,* 276 U.S. 233, and *White* v. *United States,* 305 U.S. 281. Section 115 (c) of the Internal Revenue Code (Appendix, *infra,* pp. 8-9) like its precursor, Section 201 (c) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, as construed in *Hellmick* v. *Hellman, supra,* placed shareholders' gains from liquidations upon the same basis, for computation of the tax, as gains from the sale or exchange of property.[1] The reports of the Congressional Committees discussing Section 201 (c) of the Revenue Act of 1924, c. 234, 43 Stat. 253, make it plain that that section, the relevant portion of which is identical with Section 115 (c) of the Internal Revenue Code, was intended to require gains upon corporate liquidations to be brought into the computation of the tax in the same manner as corresponding gains from sales.[2]

2. The statutory provisions were properly applied in this case. Amounts distributed in complete liquidation under the general rule provided by Section 115 (c) are by express direction of the statute

---

[1] Section 201(c) of the 1918 Act, omitted from the Revenue Act of 1921, reappeared in the 1924 Act and was continued, so far as now relevant, in the form in which it later appeared in Section 115(c) of the Revenue Acts of 1928, c. 852, 45 Stat. 791; 1932, c. 209, 47 Stat. 169; 1934, c. 277, 48 Stat. 680; 1936, c. 690, 49 Stat. 1648, and the Internal Revenue Code.

[2] S. Rep. No. 398, 68th Cong., 1st Sess. pp. 11-12 (1924) (1939-1 Cum. Bull. (Part 2) 266, 274); H. Rep. No. 179, 68th Cong., 1st Sess., pp. 11-12 (1924) (1939-1 Cum. Bull. (Part 2) 241, 249-251).

"treated as in full payment in exchange for the stock". Accordingly, under the general rule for corporate liquidation (Section 115 (c) as explained by Treasury Regulations 111, Section 29.115-5 (Appendix, *infra*, p. 9)), the transaction is regarded as a sale or exchange of the stock for the liquidation distribution, the resulting gain or loss is treated as capital gain or loss governed by and subject to the limitations of Section 117 of the Internal Revenue Code. Here, therefore, when the taxpayer "sold" his stock to the corporation in 1945 for $52,783.56, he realized a gain in that amount and was required to report the sum of $26,391.78 as a long-term capital gain.[3]

3. There are no conflicting decisions requiring resolution by this Court. *Eisner* v. *Macomber*, 252 U.S. 189, relied on by the taxpayer (Pet. 7-8), in no way implies that the difference between the basis of taxpayer's capital stock and the fair market value of the property received by him upon the liquidation of Better Housing, Inc., constitutes unrealized income. Rather, that case, in so far as is pertinent here, held (p. 207):

> "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle Case*, [247 U.S.] 183, 185 * * *.

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[3] See *Osenbach* v. *Commissioner*, 198 F. 2d 235 (C.A. 4th); *Helvering* v. *Syndicate Varieties*, 140 F. 2d 344 (C.A. D.C.).

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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MARCH, 1954.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(c) [as amended by Sec. 147 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under

section 111, but shall be recognized only to the extent provided in section 112. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.115-5. *Distributions in Liquidation.* —Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part of full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and section 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112, and shall be subject to the conditions and limitations provided in section 117.

* * * * *

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